MCI Telecommunications Corporation

1801 Pennsylvania Avenue, N.W.
Washington, DC 20006
202 887 2551
Fax: 202 887 2204
Internet: 0006343251@MCIMAIL.COM

Mary L. Brown
Director
Corporate Rates &
Federal Regulatory Analysis

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May 30, 1996

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; CC Docket No. 96-98

Dear Mr. Caton:

Enclosed herewith for filing are the original and sixteen (16) copies of MCI Telecommunications Corporation's Reply Comments regarding the above-captioned matter. Pursuant to the Commission's request, MCI is also submitting by separate cover a 3.5 inch diskette using MS DOS 5.0 and WordPerfect 5.1 software, containing our enclosed comments.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI Reply Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Mary L. Brown/sm

Mary L. Brown

Enclosure
MLB

cc: Janice Myles -- Room 544 (5 copies)
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996	)	**CC Docket No. 96-98**
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REPLY COMMENTS OF MCI TELECOMMUNICATIONS CORPORATION

Of Counsel:

Anthony C. Epstein
Donald B. Verrilli
Maureen Del Duca
Jenner and Block
601 13th St. NW
Washington, D.C. 20005

Mary L. Brown
Charles Goldfarb
Don Sussman
MCI Telecommunications Corp.
1801 Pennsylvania Ave. NW
Washington, D.C. 20006

May 30, 1996

Summary

The 1996 Act signifies a major departure from the legal and economic environment that emerged from the Communications Act of 1934. The 1996 Act paves the way for a new, forward-looking, regulatory regime that will permit any carrier to compete effectively in all telecommunications markets. The 1996 Act empowers the Commission to formulate a set of uniform national rules to remove expeditiously artificial impediments to competition in local markets so that effective competition can develop wherever the underlying cost structure is consistent with multiple efficient providers.

Many of the incumbent local exchange carriers (ILECs) argue that these rules should be broad, setting only minimum standards, and that competition is best promoted by private negotiations between parties. The notion that unconstrained negotiations between monopolists and their would-be competitors would produce pro-competitive agreements -- let alone that they "invariably will produce results better than anything that can be produced by regulatory fiat," is absurd, for the monopolist's self-interest lies squarely in delay and obstruction. While the RBOCs give lip service to the pro-competitive goals of the Act, their comments reveal most acutely that they will inevitably seek to retain the competitive advantages accruing to them by virtue of their monopoly status -- advantages they would never enjoy were the local market already competitive.

ILECs have the incentive to price in ways that will reduce competition and frustrate the goal of the 1996 Act. Therefore, the Commission must prescribe a method that is consistent both among ILECs and over time. MCI's Comments showed that the total service long run incremental costs (TSLRIC) generated by the Hatfield Model provide the best available cost

estimates that should be used as presumptive price ceilings. Unless the Commission ensures the quick adoption of actual prices, through the presumptive price ceiling proposed in MCI's earlier comments, the promise of early competition through national rules will be left unfulfilled.

If economists are united by any single proposition, it is that historical or embedded costs are irrelevant to economic decision-making. As an empirical matter, pricing interconnection and unbundled network elements at TSLRIC will not result in ILECs having to recover very large amounts of shared and common costs through markups on their retail services. As MCI explained in its comments, and contrary to the assertions of the ILECs, the recovery of shared and common costs is not a significant issue when costing is performed for network elements rather than for individual services. As AT&T suggests, it would be consistent for the Commission to require ILECs to recover any shared costs from the individual network elements on the basis of the costs that are attributable. The ILEC support for the Efficient Component Pricing Rule (ECPR) is simply a back door attempt to collect uneconomic costs in the rates for interconnection and unbundled network elements. As U S West International has stated, the ECPR ". . . is effectively a tool to protect incumbent monopolists."

Interpreting Sections 251(c) and 252(d) to apply to toll access charges would indisputably further the purposes of the Act. A striking consensus emerges from the comments that the current access charge system cannot co-exist with the interconnection regime required by that Act and that its immediate reform is essential. It only makes sense to interpret the Act to address all critical parts of an admittedly interrelated system. Any further delay in reducing access to cost will only further harm the development of effective local competition. It will also

preclude the Commission from granting any BOC application to provide in-region interexchange services because no BOC will fully implement the competitive checklist as required by Section 271(c)(2)(B)(i) and (ii) until it reduces access to cost, and because BOC entry while access charges remain inflated would harm both local and interexchange competition and therefore be contrary to the public interest.

The ILEC proposals for technical feasibility, interconnection, and unbundling would stifle any interconnection and unbundling beyond the limited dimensions available today. The ILECs' proposed *bona fide* request process would create significant delays. Negotiations could not succeed in the absence of national rules which (1) place the burden of proof on the ILEC to demonstrate that a telecommunications carrier's request to interconnect at a point on its network or obtain an unbundled element is technically infeasible; (2) require a regulatory determination of the validity of any ILEC claim of technical infeasibility within 30 days of either party seeking arbitration; (3) require ILECs to provide all information needed by requesting carriers to determine where interconnection or unbundling is most likely to be technically feasible; and (4) require each ILEC to fully implement the minimum requirements for nondiscriminatory access to unbundled elements and points of interconnection within six months of the conclusion of initial negotiations and arbitration, with explicit penalties for failure to implement.

Similarly, the ILECs' unbundling proposals would stifle the development of competition in local telecommunications markets. The ILECs' refusal to unbundle the local loop into its subelements would force requesting carriers to purchase loop subelements they can provide themselves. Their refusal to offer an unbundled local switching element that can be used to

provide all local exchange services would deny requesting carriers access to all the features, functions, and capabilities residing in the switch facilities and equipment. As a result, requesting parties would be excluded from the switched access market and artificially forced to provide vertical features as resold services. Finally, ILECs' refusal to unbundle their databases and signaling systems would keeps other providers from offering advanced services.

ILEC reciprocal compensation proposals that would force new entrants to mirror the ILEC network must also be rejected. Such requirements would force the new entrant to pay additional charges and would keep the entrant from recovering its own network costs. The only neutral way to allow different network architectures to co-exist is to allow each carrier to designate one point of interconnection on the other carrier's network, and to employ a bill-and-keep compensation arrangement.

Because this rulemaking proceeding represents the first step in the implementation of the interconnection sections of the 1996 Act, it is inevitable that some adjustments of the initial rules will be necessary as the Commission and the industry gain experience with their operation and practice. MCI therefore proposes that the Commission keep this proceeding open and seek comment six months after the rules have been promulgated on August 8, and use the experience of the parties to revise its rules where appropriate.

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Implementation of the Local Competition Provisions in the Telecommunications Act of 1996	)	**CC Docket No. 96-98**
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	)	

REPLY COMMENTS OF MCI TELECOMMUNICATIONS CORPORATION

I. Introduction

MCI Telecommunications Corporation (MCI), pursuant to the Notice of Proposed Rulemaking in the above-captioned docket,[1/] hereby submits its Reply Comments. In the Notice, the Commission asked for comment on rules to implement Sections 251, 252, and 253 of the Telecommunications Act of 1996.[2/] On May 16, 1996, nearly 170 parties filed comments. In this reply, MCI responds to comments on pricing issues, technical feasibility, and several other issues.

1/ Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, FCC 96-182, released April 19, 1996 (Notice).

2/ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56. In our comments, MCI refers to the new statute as either "the 1996 Act" or "the Act."

The 1996 Act signifies a major departure from the legal and economic environment that emerged from the Communications Act of 1934. It paves the way for a new, forward-looking, regulatory regime that will permit any carrier to compete effectively in all telecommunications markets. The 1996 Act empowers the Commission to formulate a set of uniform national rules to remove expeditiously artificial impediments to competition in local markets so that effective competition can develop wherever the underlying cost structure is consistent with multiple efficient providers.

Many of the incumbent local exchange carriers (ILECs) argue that these rules should be broad, setting only minimum standards, and that competition is best promoted by private negotiations between parties.[3/] The notion that unconstrained negotiations between monopolists and their would-be competitors would produce pro-competitive agreements -- let alone that they "invariably will produce results better than anything that can be produced by regulatory fiat," is absurd, for the monopolist's self-interest lies squarely in delay and obstruction.[4/]

The ILECs' dogged attachment to the status quo is revealed again and again in their comments. Evidence that the Regional Bell Operating Companies (RBOCs) will not willingly encourage a new competitive world emerges, for example, from their invocation of a so-called "social compact" that purportedly promises them monopoly profits in perpetuity, revealing just how little price cap and incentive-based regulation have changed monopoly pricing. It emerges from their repeated insistence that the question of what types of interconnection and unbundled

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3/ See, e.g., Ameritech Comments at 6-7; NYNEX Comments at 3; SBC Comments at 5-12.

4/ Bell Atlantic Comments at 3.

access are technically feasible should be answered by existing national technical standards[5/] -- standards developed under the auspices of Bellcore, and at a time when, by their own admission, the RBOCs lacked any incentive to approve interconnection standards that would promote, or even permit, local competition.[6/] It emerges from their persistent cry that they must be allowed to recover their historical costs[7/] -- a privilege enjoyed by no firms operating in competitive markets. It emerges from their suggestion that competitors should continue to subsidize their operations through concededly inflated access charges.[8/] It emerges from their suggestion that a party that attempts to negotiate an issue not expressly required to be negotiated by the Act should be deemed not to be negotiating in good faith[9/] -- a notion wholly inconsistent with any plausible conception of voluntary negotiations in a competitive market. And it emerges from their support of nondisclosure agreements[10/] -- a practice that assures that the monopolist supplier of inputs will have an inherent tactical advantage in negotiations. In sum, while the RBOCs give lip service to the pro-competitive goals of the Act, their comments reveal most acutely that they will inevitably seek to retain the competitive advantages accruing to them by virtue of their monopoly

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5/ See, e.g., Pacific Comments at 24; SBC Comments at 29-31, 82.

6/ See, e.g., NYNEX Comments at 64.

7/ See, e.g., Bell Atlantic Comments at 36; BellSouth Comments at 57; NYNEX Comments at 51.

8/ See, e.g., Bell Atlantic Comments at 11-12.

9/ BellSouth Comments at 11.

10/ See, e.g., Bell Atlantic Comments at 48-49; US West Comments at 40.

status -- advantages they would never enjoy were the local market already competitive. Theirs is a backward-looking vision, seeking to preserve as much market power as possible while enabling them to cast the illusion of local competition that is the key to their ability to compete fully in the long distance market.

Of course, the existence of local competition is only an illusion. In their 1996 access tariff filings, the ILECs increased access costs by more than $8 million industry wide, an increase no doubt suppressed by the option of electing a 5.3 percent productivity factor that entitles the ILEC complete freedom from obligations to share high earnings with ratepayers.[11/] Meanwhile, evidence of downward competitive pressure on pricing is slim, limited to cases where an ILEC has unlawfully attempted to create customer-specific prices to frustrate competitive entry, or has otherwise acted to quash emerging competition.[12/]

Congress recognized that competition could not take root, nor develop, under current conditions. It therefore set very short time frames by which the Commission must establish the uniform national rules by which carriers will compete in all telecommunications markets. New, forward-looking rules, aimed at creating pro-competitive conditions in the marketplace and at the negotiating table, will enable consumers to enjoy the benefits of competition in local telecommunications markets quickly.

11/ All of the RBOCs except US West elected a 5.3 productivity factor in their 1996 annual access filing.

12/ In the Matter of Southwestern Bell Telephone Company, Tariff F.C.C. No. 73, CC Docket No. 95-140, Transmittal Nos. 2433 and 2449, Order Terminating Investigation, 11 FCC Rcd 1215 (1995).

This rulemaking proceeding represents the first step in the implementation of the interconnection sections of the 1996 Act. All the parties -- ILECs, new entrants, consumers, and regulators -- are treading new ground. It is inevitable that some adjustments of the initial rules will be necessary as the Commission and the industry gain experience with their operation and practice. For example, it may turn out that the relatively limited rules proposed by MCI need to be strengthened and made more specific. MCI therefore proposes that the Commission keep this proceeding open and seek comment six months after the rules have been promulgated on August 8, and use the experience of the parties to revise its rules where appropriate.

II. The Comments Provide Broad Support for TSLRIC Pricing of Interconnection and Unbundled Network Elements

There is widespread agreement in the comments that the prices of interconnection and unbundled network elements should be set at economic cost and that total service long run incremental cost (TSLRIC) is the proper measure of those costs. The broad support of TSLRIC is not limited to new entrants, but extends to federal and state regulatory bodies.[13/] According to the U. S. Department of Justice ("DOJ"):

> In adopting standards governing the prices that ILECs may charge for the provision of unbundled network elements, the Commission should require that such prices reflect the forward-looking, economic costs of such elements. The total service long run incremental cost ("TSLRIC") of each element is an appropriate standard in this context.[14/]

13/ See, e.g., Connecticut Department of Utility Control Comments at 10; Florida Public Service Commission Comments at 26; Kentucky Public Service Commission Comments at 5; Michigan Public Service Commission Staff Comments at 13.

14/ DOJ Comments at 27.

DOJ goes on to point out that this standard is consistent with the Act[15/] and will promote competition.[16/]

A. The Comments Show That Prices for Interconnection and Unbundled Network Elements Should Be Based on Economic Cost

The ILECs attach statements from a number of economists regarding proper costing standards. A careful reading of these statements shows that agreement on the use of economic costing standards for setting interconnection and unbundled network element prices is almost universal. Professor Jerry A. Hausman concludes that:

> Economic efficiency requires that goods and services be produced in the least cost manner. Cost based prices for interconnection, unbundled network elements, and transport and termination will lead both the seller and the buyer of those services to make economically efficient choices.[17/]

Robert G. Harris and Dennis A. Yao point out that "as a matter of first principle, then, the Commission's rules should promote allocative, technical and dynamic efficiency."[18/] Economists understand that allocative, technical and dynamic efficiency are promoted by prices set at economic cost. Robert W. Crandall points out that "from an economic standpoint, the pricing of

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15/ DOJ Comments at 28-32.

16/ BellSouth claims that TSLRIC "is not a true term of art in economics and there does not appear to be a standard accepted definition in the industry." (BellSouth Comments at 50). However, a number of diverse parties, as well as economists providing supporting statements, in this proceeding provide consistent definitions of TSLRIC.

17/ Affidavit of Professor Jerry A. Hausman at 1, submitted with USTA and Bell Atlantic Comments.

18/ Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange," May 16, 1996 at 2, submitted with Comments of U S West.

any network function, whether for termination, interconnection, or any other purpose, should be based on long-run incremental costs . . . .[19] Edward Beauvais points out that "economic theory is absolutely clear that the relevant costs to look at in making pricing decisions are incremental costs."[20] Dr. Beauvais goes on to point out that the Commission should ". . . avoid any linkage between FDC cost study results and pricing."[21]

Strategic Policy Research ("SPR") filing on behalf of BellSouth refers to the ". . . Commission's mischaracterization of the optimality of incremental cost pricing in its Notice...."[22] However, a major concern for SPR appears to be to promote prices that encourage efficient entry.[23] Prices set at economic cost will in fact do this.

Economists filing for other parties also embrace the fundamental proposition that economic costs are required.[24]

19/ Declaration of Robert W. Crandall at 6, filed with Comments of Bell Atlantic.

20/ Affidavit of Edward C. Beauvais at 2, submitted with Comments of GTE.

21/ Id. at 3, emphasis in original.

22/ Interconnection and Economic Efficiency, Jeffrey H. Rohlfs, John Haring, Calvin S. Monson, and Harry M. Shooshan III, May 15, 1996, submitted with Comments of BellSouth.

23/ Id. at 2.

24/ See Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig at 4-6, submitted with Comments of AT&T; Declaration of Bruce M. Owen at 15, submitted with Comments of National Cable Television Association; also see Ameritech Comments at 65.

B. TSLRIC Pricing Will Allow Full Recovery of Economic Cost

While there is agreement among the economists that prices for interconnection and unbundled network elements should be set at economic cost, there is some disagreement about whether TSLRIC will accomplish that result.[25/] But in practice, the Hatfield Model (Version 2.2, Release 1) of TSLRIC costs, attached to AT&T's Reply Comments, will not lead to under recovery of the economic costs providing interconnection and unbundled network elements. MCI, which co-sponsored the development of the Model, fully endorses using the Model to set presumptive rate ceilings for unbundled network elements.

As a theoretical matter, the TSLRIC of a specific network function might not include economic shared or common costs. As defined in the comments of several parties, shared costs are the costs incurred for the benefit of a subset of the firm's services, while common costs are limited to true economic overhead costs relating to all of the firm's services -- i.e., the costs of supporting the administrative functions of the firm.[26/] Software supporting a number of individual unbundled features, but unattributable to any one of them, is an example of shared costs. In effect, shared costs are part of the TSLRIC of the group of services they support. As MCI noted in its comments, those shared costs should be recovered in the prices of

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25/ NYNEX presents a curious argument against the use of TSLRIC. It states that ". . . the only pertinent costs for a particular carrier are the costs that it will incur given the commitments it has undertaken and the facilities that it has already acquired." NYNEX Comments at 53. This appears to be a short run standard that would result in prices for interconnection and unbundled network elements far below TSLRIC.

26/ See e.g., AT&T Comments at 62; MCI Comments at 64; TCC Comments at 26-27, Ameritech Comments at 67.

interconnection and unbundled network elements that actually share the costs.[27/]

Economic theory does not provide a formula for allocating shared costs. However, this does not mean that ILECs should be given unbridled discretion over how shared costs are recovered. They have the incentive to price in ways that will reduce competition and frustrate the goal of the 1996 Act.[28/] Therefore, the Commission must prescribe a method. Such a method should be consistent both among ILECs and over time. AT&T's suggestion that shared costs be recovered from the individual network elements on the basis of the costs that are attributable would provide such consistency.[29/]

An efficient firm in a competitive market will recover all of its economic overhead costs. However, these costs are common to all of the firm's services. The ILEC's presence in both competitive and non-competitive sectors of the market provides it with an opportunity to distort competition by collecting a disproportionate amount of its common costs from competitors.[30/]

The optimal rule would require that the ILEC collect all common costs at the retail level. This would ensure that a telecommunications carrier is not burdened by both paying for its own economic overhead and subsidizing the overhead expenses of its competitor.[31/] In this case, all

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27/ MCI Comments at 66.

28/ See DOJ at 31-32 and Baumol, Ordover and Willig at 3-4.

29/ AT&T Comments at 64; also see TCC Comments at 19.

30/ SBC proposes a floor and ceiling approach with LRIC as the floor and current access rates as a ceiling. SBC Comments at 93-94. This would provide ILECs with virtually unbridled discretion to price in anticompetitive ways.

31/ See MCI Comments at 67.

of the benefits of economies of scale and scope are shared equally by all end users who are served by the network -- both ILEC customers and purchasing carriers' customers. As Professor Hausman states, "economic analysis demonstrates that one should tax final goods and services, not intermediate goods. Taxation of final goods leads to the economically efficient outcome."[32/]

If the Commission decides these costs are to be collected from all services and facilities an ILEC offers, including interconnection and unbundled network elements, then the Commission should take into account competitive considerations. In particular, strict imputation would be required.[33/] Allocating these costs to services or facilities on the basis of their TSLRIC would minimize the opportunity for ILECs to harm competitors through strategic pricing.

As an empirical matter, pricing interconnection and unbundled network elements at TSLRIC will not result in ILECs having to recover very large amounts of shared and common costs through markups on their retail services. As MCI explained in its comments, and contrary to the assertions of the ILECs, the recovery of shared and common costs is not a significant issue when costing is performed for network elements rather than for individual services. DOJ provides a useful explanation:

> A number of different services are sometimes optimally provided over the same shared physical facility, potentially creating common costs between those services. Thus, using a standard based on the additional costs of providing

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32/ Hausman Aff. at 5, n. 2.

33/ See Baumol, Ordover, and Willig Aff. at 14, n. 7. Also, MCI's experience is that imputation sounds better in theory than it works in practice. For example, difficult implementation issues are created by service definition. Also see Franklin M. Fisher, "An Analysis of Switched Access Pricing and the Telecommunications Act of 1996," at Attachment 1.

> services is likely to lead to an under-recovery of costs in this situation. Using TSLRIC based on physical elements greatly reduces or eliminates the problem.[34/]

This phenomenon is clearly seen in the methodology of the Hatfield Model. The cost of an unbundled loop includes all investments, associated expenses, and profit required to provide loops.[35/]

To the extent there is some economic overhead to recover, the Hatfield Model addresses the issue directly. The economic costs of supporting a firm likely grow with the size and scope of the firm -- there will be some additional costs that cannot be attributed to any particular service or element or group of services or elements. That is, a large multiproduct firm will have larger total economic overhead than a small specialized firm. In recognition of this, the Hatfield expense module includes a ten percent economic overhead cost factor for each basic network function. The ten percent factor used to account for these "variable support" expenses is comparable to the equivalent expense factor for more competitive industries. This means that virtually all economic overhead costs will be included in the estimated unbundled network element and interconnection costs -- and thus will be recovered from the prices charged for these and the network element prices imputed in the rates for the ILEC retail services that use the network elements. If there are measurable economic overhead costs not recovered from this

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34/ DOJ Comments at 32, emphasis in original. TCC makes this point as well. See TCC Comments at 18.

35/ Professor Hausman states that "fixed and common costs are typically estimated about 50% or more of total LEC costs, or revenue requirements." Hausman Aff. at 4, n. 1. This may or may not be correct as applied to a comparison of TSLRIC with an historical revenue requirement. It is clearly wrong when comparing TSLRIC of interconnection and unbundled network elements to total economic cost.

factor, a mark-up based on attributable costs would not cause a significant reduction in economic efficiency.

The ten percent factor in the Hatfield Model is substantially less than the embedded amounts assigned to overhead functions by ILECs. The size of the ILEC embedded overheads may be explained by a variety of factors, including inadequate Part 64 regulated/non-regulated cost allocations, and the presence of substantial infrastructure to support existing and potential competitive regulated services such as Centrex, interLATA long distance, video services and foreign ventures.[36/] In any event, after application of the ten percent factor in the Hatfield Model, remaining economic overhead expenses, if any, are likely quite small. These remaining expenses include primarily executive and treasury operations. Overhead expenses per unit of output would be trivial for companies the size of the ILECs.

C. Rates Set at TSLRIC Will Not Discourage Efficient Entry

The ILECs' allegations that setting the rates for unbundled elements at cost will discourage new entrants from deploying their own facilities is both analytically incorrect and, in light of their negotiating tactics, disingenuous. Only by setting unbundled elements at cost -- excluding economic overheads that all competitors will have to recover from their retail services and also excluding inefficiencies in embedded costs that could not be recovered in a competitive

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36/ The Commission itself has recognized the inadequacy of the Part 64 Rules. See In the Matter of Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, Notice of Proposed Rulemaking, released May 10, 1996. See, also, Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, 8 FCC Rcd 8071 (1993).

market -- can new entrants make efficient buy/lease decisions. If unbundled element rates are set above cost, thus encouraging new entrants to deploy noneconomic facilities rather than pay the inflated lease prices, the ILECs would then cry shrilly that they are suffering from "stranded investment," the costs of which they should be allowed to recover.

The ILECs' actual behavior in negotiations to date belies their alleged concern that facilities-based competition be fostered. During negotiations with one ILEC, the senior negotiating executive explicitly asked what his company could do to keep MCI from pursuing a facilities-based strategy in its state, raising, among other options, the possibility of MCI moving its switch to another state. Another ILEC proposed resale rates with deeper discounts for term agreements, with the intention of discouraging entrants from deploying their own facilities.[37/]

D. Historical Costs Are Irrelevant for Pricing Interconnection and Unbundled Network Elements

The ILECs devote considerable time and attention attempting to convince the Commission that embedded costs should be included in the prices of interconnection and unbundled network elements. If economists are united by any single proposition, it is that historical or embedded costs are irrelevant to economic decision-making. Nevertheless, several of the economists filing papers in support of the ILECs attempt to justify inclusion of embedded costs in the price of interconnection and unbundled network elements.

These economists resort to three related arguments in their support of uneconomic pricing

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37/ Unfortunately for competition, the ILECs' desires to frustrate facilities-based competition do not appear strong enough to incent them to provide minimally sufficient wholesale prices for the resale of LEC services.

of interconnection and unbundled network elements: 1) the current rate structure contains inefficiencies (regulatory distortions); 2) universal service must be preserved; and 3) a regulatory compact must be preserved. These arguments were weak even before the passage of the 1996 Act. The new legislation makes it clear that ratepayers are no longer to be burdened with the ILEC inefficiencies and cost-misallocations of the past.

Hausman [38] and SPR[39] argue that distortions in the current rate structure justify allowing ILECs to charge inefficiently high prices. These arguments are, at best, misguided. Excessive prices for interconnection and unbundled network elements are economically inefficient.[40] The competitive entry that the 1996 Act allows is designed to help consumers. Placing the existing inefficiencies into the post-legislation rate structure by allowing ILECs to lay-off existing inefficiencies on the prices competitors must pay for interconnection and unbundled network elements is not economically efficient -- and will not help consumers.

Allowing ILECs to recover these costs will protect the economic interests of a particular class of competitors at the expense of competition. The statements of the ILEC economists point out the dangers of favoring a particular class of competitor.[41] Stated alternatively, as MCI noted in its initial Comments, the objective of the legislative exercise was not to protect the interests of the ILECs in the status quo.

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[38] Hausman Aff. at 4.

[39] Rohlfs, Haring, Monson, and Shooshan III at 15.

[40] See Hausman Aff. at 3, at ¶ 7, and at n. 2.

[41] See e.g., Harris and Yao at 2.

The Commission must recognize that the best way to address inefficiencies in the rate structure is to end them. The best time to start doing that is now. And the best place to start is by pricing essential monopoly inputs at cost.

Excessive prices for interconnection and unbundled network elements are not necessary to preserve universal service or to fund so-called carrier of last resort obligations. Congress chose to deal with universal service costs through a separate funding mechanism, thus rendering the claimed need for recovery entirely irrelevant. Moreover, as MCI noted in its comments, the interconnection and unbundled network element prices estimated by the Hatfield Model recover all TSLRIC costs plus some overhead costs.[42/] In other words, they are neither subsidizing nor subsidized. Therefore, there is no universal service excuse for allowing excessive interconnection and unbundled network element prices.

Professor Hausman claims that preventing ILECs from recovering historical costs will discourage future investment.[43/] This is wrong. Few economists would argue with the proposition that both ILECs and telecommunications carriers will make investment decisions based upon expected future earnings. Passage of the 1996 Act and its implementation in this proceeding will actually reduce investor uncertainty because the new rules of the game will be carefully specified and known by all participants. This will reduce risk and increase investment,

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42/ MCI Comments at 75.

43/ Hausman Aff. at ¶14, at 7, and n. 5.

contrary to Professor Hausman's prediction.[44/]

The ILEC support for the Efficient Component Pricing Rule (ECPR) is simply a back door attempt to collect uneconomic costs in the rates for interconnection and unbundled network elements. As U S West International points out, the ECPR ". . . is effectively a tool to protect incumbent monopolists."[45/] U S West International is, of course, a competitive local exchange carrier (CLEC) abroad.

Allowing ILECs to recover historical costs in rates for interconnection and unbundled network elements is not just a simple transfer of wealth from consumers to the ILECs. Including these expenses in rates competitors pay will threaten the goals of the 1996 Act. As DOJ argues:

> If the ILEC's network element is priced above its true economic cost, entrants would face higher costs of entry, because either they must purchase the element at above cost prices or must waste resources by substituting more costly elements of their own for the less costly (but higher priced) elements of the ILEC. Efficient entry (i.e., entry at minimum cost) into downstream products would be deterred or precluded.[46/]

Moreover, allowing ILECs to recover these costs from competitors will distort the competitive process in other ways. The difference between the economic cost that ILECs will incur and the

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44/ Professor Hausman's argument concerning regulatory risk might be applied to ILEC arguments in favor of postponing critical pricing and costing decisions for individual state proceedings. This would increase uncertainty and risk and reduce the investment critical to the rapid development of local competition.

45/ See US West International, A Framework for Effective Competition, transmitted with March 30, 1995 letter to Don Cruickshank, Director General, Office of Telecommunications (OFTEL), from Richard J. Callahan. OFTEL is the regulatory body in Great Britain.

46/ DOJ Comments at 29.

rates charged their competitors will allow the ILECs to engage in strategic anticompetitive conduct.[47/] Finally, the addition of uneconomic costs to the rates for interconnection and unbundled network elements is the equivalent of a tax on inputs. As both Dr. Fisher and Professor Hausman note, placing taxes on inputs is economically inefficient.[48/]

E. The Hatfield Model Provides Reasonable TSLRIC Estimates

MCI's Comments showed that the TSLRIC costs generated by the Hatfield Model provide reasonable TSLRIC cost estimates that should be used as presumptive price ceilings in order for the goals of the Act -- including the speedy arrival of local competition -- to be fulfilled.[49/] The latest version of the Hatfield Model suitable for estimating state by state rates has been provided in AT&T's Reply Comments.

Many of the criticisms are directed toward the use of the Benchmark Cost Model (BCM) for establishing the costs of interconnection and unbundled network elements. To the extent the Hatfield Model relies on the Benchmark Cost Model, appropriate extensions have been made. Other criticisms seem directed to the use of economic modeling techniques in general.[50/] Economic models are an accepted means for determining costs in regulatory proceedings.[51/] In

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47/ See Baumol, Ordover, and Willig at 3-4.

48/ Hausman Aff. ¶ 7, at 3, and n. 3, Fisher at 12.

49/ Baumol, Ordover and Willig explain why the Hatfield Model provides reasonable TSLRIC estimates. Baumol, Ordover, and Willig at 15-18.

50/ See, e.g., Crandall at 11.

51/ AT&T Comments at 49.

addition, some criticisms of the Hatfield approach are actually criticisms of using economic costing as a basis for rates.[52/]

F. TSLRIC Pricing Will Not Result in an Unconstitutional "Taking" of ILEC Property

Several ILECs raise the specter that cost-based pricing consistent with the Act would produce an unconstitutional "taking" of their property without just compensation, in violation of the Fifth Amendment. They complain that requiring them to provide unbundled network elements at prices based on TSLRIC will not allow full recovery of their actual embedded or historic costs or of certain common costs.

These efforts to "constitutionalize" the debate over economic pricing of LEC services are without legal foundation. The ILECs have no constitutional right to any particular rate-setting methodology, such as a rate-of-return methodology based on their "historical" or "embedded" costs.[53/]

Rates based on TSLRIC reflect the forward-looking costs of providing a service or facility by an efficient company using the best available technology. No ILEC has made any effort in its comments to demonstrate the actual impact on its "financial integrity" of a shift from rates based on embedded costs to rates based on TSLRIC. This is not surprising, since TSLRIC, by definition, allows the ILECs all of the costs of efficiently providing a given service or facility,

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52/ See, e.g., SBC Comments, Appendix A.

53/ Duquesne Light Co. v. Barasch, 488 U.S. 299, 315-16 (1989); Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944).